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Should China Keep Its Dollar Peg? Some Parallels from Japan

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At a recent Singapore Management University School of Economics Distinguished Lecture, Stanford University international economics professor Ronald I. McKinnon warned of a possible 'lost decade' of falling price levels and undesirably low interest rates in China, similar to those experienced by Japan in the 1990s following yen appreciation under American pressure. McKinnon, author of the book, *Exchange Rates under the East-Asian Dollar Standard,* draws parallels between Japan in the late 1980s and present day China in his paper entitled "Why China Should Keep its Exchange Rate Pegged to the Dollar: A Historical Perspective from Japan".

China–Japan Parallels

Japan twenty years ago is a good case for comparison with the present exchange rate situation in China. Says McKinnon, " In the 1970s and 1980s, Japan was the fastest growing industrial economy with its mastery of new technologies making its manufactured exports look increasingly competitive to American and European manufacturers. Indeed, it looked as if it was going to take over the world much like China today." China's burgeoning growth post-entry into the World Trade Organisation has phenomenally increased trade between China and other nations, particularly the United States. China has been running a trade surplus of trillions of dollars and, in 2003, became the largest single source of the US trade deficit. A trade deficit means that the US is paying more to foreign countries (China in this case) for the goods purchased than it earns for the goods sold to them. A Financial Times article dated June 14, 2007 claims that China's fixed exchange rate has contributed to a record annual bilateral US trade deficit of USD 233bn. This amount is over one-fourth of the total trade imbalance of the US, and US imports from China are almost six times as large as US exports to China.

Many experts claim that the renminbi (RMB) is undervalued, resulting in cheaper Chinese goods, in dollar terms, being made available to American consumers compared with domestic substitutes. This makes Chinese exports relatively more competitive. Similarly, imports from the US, priced in dollars, seem expensive to the Chinese against the RMB denominated goods made in their home country. The net effect is a trade deficit for America and, conversely, a bilateral trade surplus with the US for China. Quips McKinnon, "On Christmas Day, when American kids open their gifts, they all have 'Made in China' labels!"

This was exactly the situation with Japan in the late 1980s. Japan was a highly industrialised nation whose exports flooded the American market. Unable to compete, American factories faced shut-downs, workers lost their jobs, and there was tremendous political pressure from America on Japan to appreciate the yen in the hope of reducing Japan's trade surplus and, thereby, America's deficit. As in the case of Japan, the exchange rate of the Chinese currency, the yuan or RMB, is based on a fixed-exchange rate regime. Unlike a floating exchange rate system, in a fixed system the central bank intervenes in the currency markets to artificially control the exchange rate of their currency. The exchange rate of the RMB is determined by the People's Bank of China (PBC) rather than by demand and supply for the RMB on global currency markets. Since 1995, the exchange rate of the RMB against the USD was fixed but there was a revaluation in July 2005. The PBC has pegged the RMB to the USD at 8.28 per USD. PBC buys up excess dollars in the forex markets. As the supply of RMB increases relative to that of the US dollar, the RMB depreciates relative to USD, thus maintaining an artificially undervalued rate.

This phenomenon has led to the widespread belief that a revaluation of the renminbi will rectify these trade imbalances. Thus, there is tremendous pressure from the US on China, just as there was in the case of Japan about a decade ago, to allow the yuan to appreciate.

Mistaken Beliefs

McKinnon warns that this is amistake. "Rather than an undervalued renminbi, it is the structural deficits in the US and the undesirably low private savings which cause such trade imbalances" In fact, he predicts that a revaluation of the renminbi would not have the widely believed effect of reducing the US trade deficit, just as the yen appreciation in the late 1980s failed to produce any significant reduction of Japan's surpluses.

McKinnon adds, "The current US-China trade frictions are reminiscent of US-Japan frictions from the 1970s through to 1995". The increasing imports of Japanese goods into America at that time led to huge political pressure on Japan, popularly known as Japan-bashing. The Japanese government yielded by allowing the yen to appreciate, but this eventually led to deflation in the country and a zero-interest liquidity trap. Expectations of the yen appreciation were so high that interest rates fell to almost zero. Savings and investments suffered, fuelling a continued slump in the economy, while Japan's trade surpluses were not reduced. Mckinnon fears that history may repeat itself if appropriate policy measures are not implemented.

According to McKinnon, such flawed thinking which caused both Japan bashing and, now, China bashing, is a result of two factors: politics, and the underlying economic issues. As American industry becomes less competitive compared to the Chinese, American consumers substitute Chinese imports for domestically produced goods. American manufacturers suffer, some shut down while others cut back on operations. The resulting lay-offs in the US cause trade unions to lobby the politicians who, in turn, pressurise China to revalue the RMB, hoping that this would rectify the woes of the US. "Blaming foreigners for misaligned exchange rates is easier than facing up to the problem of inadequate private saving and large structural deficits in the United States," says McKinnon.

China has also accumulated huge dollar reserves as a result of its currency interventions. Already a large creditor to the US, its recent investment in American private equity company, Blackstone, was a rude shock to the US. It was seen by some as a threat in the direction of a gradual nationalisation of America's private sector by the Chinese government. Singapore, which also has very high foreign reserves in relation to its GDP and had also bought a stake in the American firm, did not incur such political wrath. "Singapore does a very good job at managing its reserves quietly", says McKinnon. "It has nationalised private savings into the Central Provident Fund which is then invested by the experts at government agencies in confidentiality. This could be a model for other Asian countries to follow."

McKinnon also believes that the popular elasticities approach to balance of trade is also to blame. He warns, "Most mainstream economists believe that a government can control its real exchange rate and thereby control the real trade balance. However, this model is incomplete." In the short and medium term, prices are generally 'sticky' or unchanging. If currency appreciation were to take place in a creditor economy like China, exports are expected to decline and imports increase, thus reducing the trade surplus. However, this is not what really happens because there are some offsetting effects of appreciation on national income and consumption.

If the RMB appreciates, a fall in exports as well as import substitutes will reduce national income. Since consumption decisions depend on income, people will consume less and spend less. As a result, spending on imports falls as well. Besides, due to a more expensive yuan, foreign investment as well as domestic investment will be reduced. This causes a further decline in expenditure on imports. Also, dollar assets held by China in the form of official reserves can lose value, adversely affecting domestic consumption and investment. These effects will offset the trade balance correction that was expected.

In the short term, since there are no price level changes, the real exchange rate is the nominal rate. In the long term, however, with changing price levels can such a real appreciation be sustained? An appreciating yen led to deflationary pressures in the Japanese economy during the 1990s. Interestingly, because Japan's price level fell relative to the US, the yen's real exchange rate was back to the 1980s level in 2000, despite an appreciation in nominal terms. States McKinnon, "By purchasing power parity, there was no sustained appreciation in Japan's real exchange rate. Nor has there been any sustained reduction in its current account surplus." Thus, a forced yen appreciation turned out to be futile for America and ruinous for Japan. "As in the Japanese case, China's surplus saving -- its current account surplus -- is unlikely to diminish as its currency appreciates. Instead, China's economic growth would slow and its price level would start declining," predicts McKinnon.

Exchange Rate and Monetary Policy

"Floating the renminbi, which would lead to a large initial appreciation, would be a major policy mistake," says McKinnon. The trade surplus would be unaffected, while there will be continuous appreciation until the government intervenes and stabilises it again at a much higher rate. "By then, expectations of ongoing appreciation and deflation in China would be firmly in place, much like what happened to Japan with its ever higher yen in the 1980s to the mid-1990s, leading to Japan's deflationary slump with a zero interest liquidity trap and its lost decade of the 1990s," he adds.

Most global trade is invoiced in the US dollars and most countries in Latin America, Africa, and Asia are on the US dollar standard. Says McKinnon, "China is no exception and hence the US dollar has been a stable monetary anchor for it until recently." In fact, he believes that, in the long run, both Japan and China should have stabilised rates against the dollar to prevent extremely low interest rates and deflationary traps. However, for a peripheral country on the dollar standard like China, the USD is not a stable peg at present with inflation rising in the US. Hence, McKinnon recommends a short term solution in monetary policy while aiming for a fixed rate in the long run.

He suggests that since the exchange rate and monetary policy are mutually determined, China should now use the exchange rate as part and parcel of monetary policy to target inflation level. The policy, since July 2005, to allow the RMB to slightly appreciate against the dollar has not affected the surplus much, but has had a positive effect on China's inflation. It has insulated China from rising inflation in the US.

McKinnon proposes a new monetary rule for China whereby the appreciation in RMB is just equal to the difference between the American inflation rate and the target inflation rate of China. He states, "When a highly open economy like China gears its domestic monetary policy to a slow, but well-signalled appreciation against the US dollar, its price inflation can be expected to fall correspondingly below the American rate." As the RMB appreciates by the inflation rate differential between the target rate in China and the actual rate of inflation in US, the corresponding deflationary pressures on the Chinese economy will bring it to its target inflation rate. According to McKinnon, "If inflation in the US reduces, China's upward crawl should slow correspondingly and stop when American inflation stabilises at China's internal target rate".

Thus China's central bank should formulate its own exchange rate based monetary policy in careful alignment with inflation and interest rates in the US. Any exchange rate appreciation should be gradual. In the long run, as US inflation stabilises, China should keep its exchange rate fixed, as it had been until July 2005, in order to avoid the deflation and zero interest rates that Japan is still trying to recover from.

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